STATEMENT OF INVESTMENT POLICY

CITY OF CARLSBAD

Jim Stanton, City Treasurer
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Approved by City Council January 14, 2003

1.0 Introduction. The purpose of this document is to identify various policies and procedures that enhance opportunities for a prudent and systematic investment policy and to organize and formalize investment-related activities. Related activities, which comprise good cash management, include accurate cash projections, the expeditious collection of revenue, the control of disbursements, cost-effective banking relations, and arranging for a short-term borrowing program, which coordinates working capital requirements and investment opportunities.

2.0 Policy. It is the policy of the City of Carlsbad to invest public funds not required for immediate day-to-day operations in safe and liquid investments having an acceptable return while conforming to all state statutes and the City's Investment Policy governing the investment of public funds.

3.0 Scope. It is intended that this policy cover the investment activities of all contingency reserves and inactive cash under the direct authority of the City.

3.1 Pooled Investments. Investments for the City and its component units will be made on a pooled basis, including the City of Carlsbad, the Housing Authority of the City of Carlsbad, the Parking Authority of the City of Carlsbad, the City of Carlsbad Public Improvement Corporation, the Carlsbad Redevelopment Agency, and the Carlsbad Municipal Water District. The City's Comprehensive Annual Financial Report identifies the fund types involved as follows:

- General Fund
- Special Revenue Funds
- Debt Service Funds
- Capital Project Funds
- Enterprise Funds
- Internal Service Funds
- Redevelopment Funds
- Trust Funds
- Miscellaneous Special Funds
- Any new funds created by the City Council, unless specifically exempted.

3.2 Investments held separately. Investments of bond proceeds will be held separately when required by the bond indentures or when necessary to meet arbitrage regulations. If allowed by the bond indentures, or if the arbitrage regulations do not apply, investments of bond proceeds will be held as part of the pooled investments.

4.0 Objectives. Section 53600.5 of the California Government Code outlines the primary objectives of a trustee investing public money. The primary objectives, in order of priority, of the City's investment activities shall be:

> **4.1 Safety.** Safety of principal is the foremost objective of the investment program. Investments of the City shall be undertaken in a manner that seeks to ensure preservation of capital in the overall portfolio.
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> **4.2 Liquidity.** The City's investment portfolio will remain sufficiently liquid to enable the City to meet all operating requirements, which might be reasonably anticipated.
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> **4.3 Return on investment.** Investment return becomes a consideration only after the basic requirements of safety and liquidity have been met. The City shall attempt to obtain an acceptable return provided that the requirements of safety and liquidity are first met.

The City Treasurer shall strive to maintain the level of investment of all contingency reserves and inactive funds as close to 100% as possible. While the objectives of safety and liquidity must first be met, it is recognized that portfolio assets represent a potential source of significant revenues. It is to the benefit of the City that these assets be managed to produce optimum revenues, consistent with state statutes and local ordinances.

5.0 Duties and Responsibilities. By the annual adoption of this policy, the management of inactive cash and the investment of funds identified in paragraph 3.1 is the responsibility of the City Treasurer as directed by the City Council. Under the authority granted by the City Council, no person may engage in an investment transaction covered by the terms of this policy unless directed by the City Treasurer.

In the execution of this delegated authority, the City Treasurer may establish accounts with qualified financial institutions and brokers/dealers for the purpose of effecting investment transactions in accordance with this policy. The criteria used to select qualified financial institutions and brokers/dealers are identified in paragraph 14 of this policy.

The City Treasurer may designate in writing a Deputy City Treasurer, who in the absence of the City Treasurer, will assume the City Treasurer's duties and responsibilities. The City Treasurer shall retain full responsibility for all transactions undertaken under the terms of this policy.

In the endeavor to have all inactive cash invested all the time, the City Finance Director will assist the City Treasurer in the gathering of information to create cash flow estimates.

6.0 Prudence. Section 53600.3 of the California Government Code identifies as trustees those persons authorized to make investment decisions on behalf of a local agency. As a trustee, the standard of prudence to be used shall be the "prudent investor" standard and shall be applied in the context of managing the overall portfolio. Investments shall be made with judgment and care--under circumstances then prevailing--which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

Investment officers acting in accordance with written procedures and the investment policy and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk changes or market price changes, provided deviations from expectations are reported in a timely manner and appropriate action is taken to control adverse developments.

7.0 Ethics and conflicts of interest. All participants in the City's investment process shall seek to act responsibly as custodians of the public trust. Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or which could impair their ability to make impartial investment recommendations and decisions. Investment officials and employees shall make all disclosures appropriate under the Fair Political Practices Act and may seek the advice of the City Attorney and the Fair Political Practices Commission whenever there is a question of personal financial or investment positions that could represent potential conflicts of interest.

8.0 Authorized investments.

8.1 Pooled investments. The City Treasurer may invest City funds in the following instruments as specified in the California Government Code, Section 53601, and as further limited in this policy.

8.1.1 Obligations of the U.S. Government, its agencies and instrumentalities.

8.1.2 Bankers Acceptances that are eligible for purchase by the Federal Reserve System. Purchases may not exceed 180 days maturity or 25% of the portfolio.

8.1.3 Time Certificates of Deposit. Deposits should not exceed one-year maturity. Deposits will be collateralized as specified in paragraph 9.0 of this Investment Policy.

8.1.4 Negotiable Certificates of Deposit issued by nationally or state-chartered bank. Purchases may not exceed 30% of the portfolio.

8.1.5 Commercial Paper of prime quality of the highest letter and number rating as provided for by a nationally recognized statistical-rating organization such as Moody's Investment Services, Inc. or Standard & Poors Corporation. Further, eligible paper is limited to issuing corporations that are organized and operating within the United States and having total assets in excess of $500 million. If the issuer has other existing debt, it must have an “AA” or higher credit rating from either Moody's Investment Services, Inc. or Standard and Poors Corporation. Purchases may not exceed 270 days maturity or 25% of the portfolio, and may not represent more than 10% of the outstanding paper of an issuing corporation.

8.1.6 Repurchase Agreements with a maximum maturity of one week. Repurchase Agreements will only be with primary dealers of the Federal Reserve Bank of New York, and who have long-term debt rated in the "AAA" or "AA" categories of Moody's Investment Services, Inc. or Standard and Poors Corporation. Investments will be collateralized as specified in paragraph 9.0 of this Investment Policy and may not exceed 5% of the portfolio.

8.1.7 Medium-term Corporate Notes of a maximum of five years until maturity issued by corporations organized and operating within the United States and rated in the "AAA" or "AA" categories of Moody's Investment Services, Inc. and Standard and Poors Corporation. Purchases may not exceed 30% of the portfolio.

8.1.8 Money market funds (whose portfolio consists of one or more of the foregoing legal investments).

8.1.9 Sweep account for the investment of overnight funds when the funds are swept into investments allowed by this policy.

8.1.10 Local Agency Investment Fund (LAIF) of the State of California. Investments will be made in accordance with the laws and regulations governing those Funds.

Investments will be made only in readily marketable securities actively traded in the secondary market.

8.2 **Investments held separately.** Investments of bond funds will be made in conformance with the trust indenture for each issue. Such investments will be held separately when required.

8.3 **Housing Loans.** Housing loans approved by the City Council to private developers and homeowners, as part of the City housing program need not meet the investment objectives and the risk management requirements of this Investment Policy. The City Council will manage these loans directly.

As assets of the City, individual loans will be reported by the City Treasurer and any changes would be explained. Collections and conformance with the requirements of each individual housing loan will be reported as an addendum to the City Treasurer's Investment Report each quarter.

9.0 **Collateralization.** Investments in time certificates of deposit shall be fully insured up to $100,000 by the Federal Deposit Insurance Corporation or the Federal Savings & Loan Insurance Corporation, as appropriate. Investments in time certificates of deposit in excess of $100,000 shall be properly collateralized. Section 53652 of the California Government Code requires that the depository pledge securities with a market value of at least 10% in excess of the City's deposit as collateral in government securities, and 50% in excess of the deposit as collateral in mortgage pools. Section 53649 of the California Government Code specifies that the City Treasurer is responsible for entering into deposit contracts with each depository.

Investments in repurchase agreements must also be collateralized. In order to anticipate market changes and provide a level of security for all funds, the collateralization level will be 102% of market value of principal and accrued interest.

10.0 Unauthorized investments/investment activities. Section 53601.6 of the California Government Code disallows the following investments acquired after January 1, 1996: inverse floaters, range notes, or interest-only strips that are derived from a pool of mortgages. In addition, and more generally, investments are further restricted as follows:

> **10.1** No investment will be made that has either (1) an embedded option or characteristic which could result in a loss of principal if the investment is held to maturity, or (2) an embedded option or characteristic which could seriously limit accrual rates or which could result in zero accrual periods.
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> **10.2** No investment will be made that could cause the portfolio to be leveraged.

11.0 Investment strategy.

> **11.1 Pooled Investments**. A buy and hold strategy will generally be followed; that is, investments once made will usually be held until maturity. A buy and hold strategy will result in unrealized gains or losses as market interest rates fall or rise from the coupon rate of the investment. Unrealized gains or losses, however, will diminish as the maturity dates of the investments are approached or as market interest rates move closer to the coupon rate of the investment. A buy and hold strategy requires that the portfolio be kept sufficiently liquid to preclude the undesired sale of investments prior to maturity. Occasionally, the City Treasurer may find it advantageous to sell an investment prior to maturity, but this should only be on an exception basis and only when it is clearly in the best interest of the City to do so.
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> **11.2 Investments held separately**. Investments held separately for bond proceeds will follow the trust indenture for each issue.

12.0 Diversification. The portfolio will be diversified to avoid incurring unreasonable and avoidable risks regarding specific security types or individual financial institutions. In addition to the limitations on specific security types indicated in paragraph 8.0 of this Investment Policy, and with the exception of U.S. Treasury/Federal agency securities and authorized pools, no more than 5% of the City's portfolio will be placed with any single issuer.

13.0 Maximum maturities and maximum modified duration.

13.1 Pooled Investments. A policy of laddered maturities will be followed for pooled investments. The following maturity requirements will apply as of the month end of each reporting period.

13.1.1 Investments maturing within one year must be no less than two-thirds of the approved operating budget of the current year. This requirement will be met within 3 months following adoption of the current operating budget. Remaining investments of the portfolio will not have a maturity greater than 5 years from the current date except as provided in paragraph 13.1.3 of this Investment Policy.

13.1.2 The average portfolio investment maturity shall be 3 years or less. A dollar-weighted average will be used in computing the average maturity of the portfolio.

13.1.3 Before an investment is made in securities that mature more than 5 years from the current date, the City Treasurer and the Administrative Services Director will review the City's long term cash needs. Both must concur before such an investment is made. Investments beyond 5 years will not be greater than 10% of the portfolio, and will be counted in the percentage of the portfolio that may mature beyond 1 year. No investments will be made that mature beyond 10 years from the current date.

13.1.4 Callable investments will be recorded at their maturity dates.

13.2 Maximum modified duration. The investment restrictions identified in paragraphs 8.0 and 10.0, and the maturity requirements identified in paragraph 13.1, imply that the value of City investments should not change more than 2.2% for every 1% change in market interest rates. To ensure that this is the case, a maximum modified duration is established at 2.2. This states that the unrealized gains and losses of the portfolio are not expected to exceed 2.2% for every 1% change in market interest rates. A modified duration in excess of 2.2 would indicate that the portfolio is exposed to more market risk than is desired by this policy. If the modified duration of 2.2 is exceeded, an explanation will be made in the first monthly report following the occurrence.

13.3 Investments Held Separately. Maturities for investments held separately will conform to the trust indenture for each issue.

14.0 Selection of financial institutions and brokers/dealers. Investments shall be purchased only through well-established, financially sound institutions. The City Treasurer shall maintain a list of financial institutions and broker/dealers approved for investment. All financial institutions and broker/dealers who desire to become qualified bidders for investment transactions will be given a copy of the City's Investment Policy, and a return cover letter which must be signed indicating that the investment policy has been read and understood. Qualified financial institutions and broker/dealers must supply the City Treasurer with the following:

14.1 Financial Institutions.

- Current audited financial statements.
- Depository contracts, as appropriate.
- A copy of the latest FDIC call report or the latest FHLBB report, as appropriate.
- Proof that commercial banks, savings banks, or savings and loan associations are state or federally chartered.

14.2 Broker/Dealers.

- Current audited financial statements.
- Proof that brokerage firms are members in good standing of a national securities exchange.

Commercial banks, savings banks, and savings and loan associations must maintain a minimum net worth to asset ratio of 3% (total regulatory net worth divided by total assets), and must have had positive net earnings for the last reporting period.

15.0 Purchase, Payment, and Delivery. A competitive bid process, when practical, will be used to place all investment transactions. When two or more investment opportunities offer essentially the same maturity, liquidity, yield, and quality, priority will be given first to the financial institutions based in the City of Carlsbad, and second to other financial institutions in the State of California.

Purchases on margin will not be made. Payment for securities will be done on a Delivery Versus Payment (DVP) basis via the City's custodian. Delivery of securities will be made to the City in accordance with the third party custodial agreement.

16.0 Safekeeping and custody. All security transactions, including collateral for repurchase agreements, entered into by the City shall be conducted on a delivery-vs.-payment basis. All securities owned by the City will be held by a third-party custodian designated by the City Treasurer and evidenced by a monthly statement from the custodian. All securities will be held in the nominee name of the custodian. Collateral for time deposits in savings and loans will be held by the Federal Home Loan Bank or an approved Agent of Depository. Collateral for time deposits in banks will be held in the City's name in the bank's Trust Department or in the Federal Reserve Bank.

17.0 Performance standard for pooled investments. Laddered maturities and a buy and hold strategy for pooled investments will cause the investment portfolio to attain a market-average rate of return throughout budgetary and economic cycles, commensurate with the investment risk constraints and the cash flow needs. Since the amount maturing within one year must be at least equal to the currently approved operating budget, the rate of return will be more closely related to, but lag behind, changes in short-term market rates. The rate of return of the investment portfolio will be based on the maturity value of the investments. A dollar-weighted average of yields to maturity will be used in calculating the rate of return of the entire portfolio.

18.0 Reporting. Sections 53607 and 53646 of the California Government Code require reports of investments and transactions to the City Council, City Manager, and internal auditor (or the Finance Director in the absence of an internal auditor).

18.1 Pooled investments. The investment report shall be submitted monthly by the City Treasurer within 30 days following the end of the month covered by the report. The monthly report shall include the following elements:

- Itemized listing of portfolio investments by type, date of maturity, yield to maturity, and issuer.
- Par value, dollar amount invested, amortized cost, and current market value as of the date of the report will be given for the total of all securities, investments, and moneys held by the City and its component units. The source of the market values will be cited.
- Credit ratings of corporate notes
- Accrued income
- Weighted average yield of the portfolio
- Weighted average days to maturity of the portfolio from the date of the report
- Weighted average modified duration of the portfolio
- Dollar amount and percentage of portfolio maturing within one year
- Dollar amount and percentage of portfolio maturing between one and 5 years
- Percent that each type of investment represents in the portfolio
- Investment transactions for the reporting period
- Fund source of investments when available
- Statement that the investment portfolio has the ability to meet the City's cash flow demands for the next six (6) months
- Statement of compliance of the portfolio with the City's Investment Policy. When applicable, any material exceptions will be noted.

An annual report for pooled investments will also be made to the City Council following the close of the fiscal year. Among other items, the annual report will include an analysis of the composition of the portfolio with regard to fund source; a review of trends regarding the size of the fund, portfolio yields, and cash income; and a statement regarding anticipated fund activity in the next fiscal year.

18.2 Investments held separately. A report of investments held separately, including deferred compensation balances, shall be made quarterly within 30 days following the end of the quarter and submitted as an exhibit in the City Treasurer's monthly report. The quarterly report shall contain the information required by Section 53646 when available.

19.0 Short-term borrowing. The City is permitted by law to borrow money to meet current short-term cash flow needs. These needs may arise either because projected cash disbursements exceed projected cash receipts, or because the City's cash accounts may be temporarily overdrawn due to the efforts to invest 100% of inactive funds at all times. To provide for these contingencies the City Treasurer is authorized to take the following actions:

19.1 Short-term loan. When there is a shortfall between projected cash revenues and projected cash disbursements, the City Treasurer will secure a loan in the amount that would equal the cash deficit plus projected cash disbursements for one month. Any such loan will be repaid within one year.

19.2 Line of credit. The City Treasurer may maintain a line of credit with the City's bank in an amount to cover sums temporarily overdrawn because of efforts to invest all inactive funds at all times.

20.0 Exceptions. Occasionally, exceptions to some of the requirements specified in this Investment Policy may occur for pooled investments because of events subsequent to the purchase of investment instruments, e.g., the rating of a corporate note held in the portfolio is downgraded below an "AA" rating, or total assets in the portfolio decline causing the percentage invested in corporate notes to rise above 30%, or an unforeseen expenditure causes investments maturing within one year to fall below the approved operating budget of the current fiscal year.

Section 53601.7(d) of the California Government Code requires that exceptions be reviewed for possible corrective action. Exceptions may be temporary or more lasting; they may be self-correcting or require specific action. If specific action is required, the City Treasurer will determine the course of action that will correct exceptions to move the portfolio into compliance with State and City requirements. Decisions to correct exceptions will not expose the assets of the portfolio to undue risk, and will not impair the meeting of financial obligations as they fall due. Any subsequent investments will not extend existing exceptions. Exceptions, and the decisions to correct the exceptions, will be reviewed with the Investment Review Committee referred to in paragraph 22.0 below.

21.0 Internal control. This policy and the strategy for and conduct of the investment of City funds will be reviewed by an Investment Review Committee as set forth below and by the City's auditors in the conduct of their annual audit of the City.

22.0 Review. An Investment Review Committee is hereby established to conduct reviews of the City's investment portfolio, the strategy being utilized for the investment of City funds, and the City's investment policy. This Committee will be composed of the City Treasurer (acting as the Chair), the City Attorney or designee, the Assistant City Manager, the Administrative Services Director, and the Deputy City Treasurer (when not one of the foregoing). Additionally, an outside financial advisor may be included as an advisor without a vote. The Committee will convene periodically as necessary or desirable but no less frequently than once each quarter.

23.0 Investment policy adoption. Section 53646(a) of the California Government Code requires the City Treasurer to render to the City Council and the Investment Review Committee a statement of investment policy no less frequently than once each year. The City’s investment policy and any modifications thereto shall be considered at a public meeting. Adoption shall be made by resolution of the City

Council.

GLOSSARY

Amortized Cost: cost of investments adjusted for amortized premiums and discounts. Amortized cost is used to maintain comparability with market value.

Arbitrage Regulation: law to control the use of profit making by purchasing securities on one market for immediate resale on another in order to profit from a price difference.

Bankers Acceptances: investment vehicle created to facilitate international commercial trade transactions. The bank accepts responsibility to repay a loan to the holder of the investment vehicle created in a commercial transaction. The credit worthiness of Bankers Acceptances are enhanced because they are secured by the issuing bank, the goods themselves, and the importer. Bankers Acceptances are sold on a discounted basis.

Bond Indenture: written agreement specifying the terms and conditions for issuing bonds, stating the form of the bond being offered for sale, interest to be paid, the maturity date, call provisions and protective covenants, if any, collateral pledged, the repayment schedule, and other terms. It describes the legal obligations of a bond issuer and the powers of the bond trustee, who has the responsibility for ensuring that interest payments are made to registered bondholders.

Bookvalue: a term synonymous with amortized cost.

Buy and Hold Strategy: investments in which management has the positive intent and ability to hold each issue until maturity.

Collateralization: to secure a debt in part or in full by pledge of collateral, asset pledged as security to ensure payment or performance of an obligation.

Commercial Paper: short-term IOU, or unsecured money market obligation, issued by prime rated commercial firms and financial companies, with maturities from 2 days up to 270 days. A promissory note of the issuer used to finance current obligations, and is a negotiable instrument.

Delivery versus Payment: securities industry term indicating payment is due when the buyer has securities in hand or a book entry receipt.

Embedded Option: a statement within the bond structure that would alter the interest rate earned by the bond.

Interest-Only Strips: mortgage-backed instrument where investor receives only the interest, no principal, from a pool of mortgages. Issues are highly interest rate sensitive. Cash flows vary between interest periods. As well, the maturity date may occur earlier than that stated if all loans within the pool are pre-paid. High prepayments on underlying mortgages can return less to the holder that the dollar amount invested.

Inverse Floater: a bond or note that does not earn a fixed rate of interest. Rather, the interest rate that is earned is tied to a specific interest-rate index identified in the bond/note structure. The interest rate earned by the bond/note will move in the opposite direction of the index, e.g., if market interest rates as measured by the selected index rises, the interest rate earned by the bond/note will decline. An inverse floater increases the market rate risk and modified duration of the investment.

Laddered Portfolio: bond investment portfolio with securities in each maturity range (e.g. monthly) over a specified period of time (e.g. five years).

Leverage: investing with borrowed money with the expectation that the interest earned on the investment will exceed the interest paid on the borrowed money.

Local Agency Investment Fund (LAIF): a voluntary investment program offering participating agencies the opportunity to participate in a major portfolio which daily invests hundreds of millions of dollars, using the investment expertise of the State Treasurer's Office Investment staff at no additional cost to the taxpayer. Investment in LAIF, considered a short-term investment, is readily available for cash withdrawal on a daily basis.

Market Risk: the risk that market interest rates will rise causing a loss of value in investments held. All investments made by the City involve a degree of market risk. See also "Unrealized Gains (Losses).

Modified Duration: a measure of the sensitivity that the value of a fixed-income security has to changes in market rates of interest. Modified duration is the best single measure of a portfolio's or security's exposure to market risk. Modified duration identifies the potential gain/loss in value before the gain/loss actually occurs. It is a prospective measurement, e.g., a modified duration of 1.5 indicates that when and if a 1% change in market interest rates occurs, a 1.5% change in the value of a security will result. Investments with modified durations of one to three are considered to be relatively conservative.

Negotiable Certificates of Deposit: large denomination ($100,000 or more) interest bearing time deposits, paying the holder a fixed amount of interest at maturity. Issues can be sold to a new owner before maturity.

Nominee Name: registered owner of a stock or bond if different from the beneficial owner, who acts as holder of record for securities and other assets. Typically, this arrangement is done to facilitate the transfer of securities when it is inconvenient to obtain the signature of the real owner, or the actual owner may not wish to be identified. Nominee ownership simplifies the registration and transfer of securities.

Pooled Investment: grouping of resources for the common advantage of the participants.

Range Note: investment whose coupon payment varies (e.g. either 7% or 3%) and is dependent on whether the current benchmark (e.g. 30 year Treasury) falls within a pre-determined range (e.g. between 6.75% and 7.25%).

Repurchase Agreement: contract to purchase and subsequently sell securities at a specified date and price

Sweep Account: short-term income fund into which all uninvested cash balances from the non-interest bearing checking account are automatically transferred on a daily basis.

Third-Party Custodian: corporate agent, usually a commercial bank, who, acting as trustee, holds securities under a written agreement for a corporate client and buys and sells securities when instructed. Custody services include securities safekeeping, and collection of dividends and interest. The bank acts only as a transfer agent and makes no buy-sell recommendations.

Time Certificates of Deposit: deposit account paying interest for a fixed term, with the understanding that funds cannot be withdrawn before maturity without giving advance notice.

Unrealized Gains (Losses): increases (decreases) in the value of investments representing the difference between the amortized cost of the investments and their current market value. Increases (decreases) in value are caused primarily by changes in market interest rates subsequent to purchasing the investments. Increases (decreases) in value indicate two things: 1. The portfolio has a potential gain (loss) in principal if the securities are sold, and 2. The portfolio is over performing (under performing) the current market for similar investments. An increase in value indicates the portfolio is earning relatively more interest than current market conditions, and a decrease in value indicates that the portfolio is earning relatively less interest than current market conditions.

Zero Accrual Periods: a period of time in which an investment accumulates no interest.